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Shareholder Value Maximization— Is There a Role for Corporate Social Responsibility?

by John Martin and William Petty, Baylor University, and
James Wallace, Claremont Graduate University

As the first decade of the 21st century winds down, we have seen a sea change in society's attitudes toward finance. The 1990s can best be described as the decade of shareholder supremacy, with one company trying to outdo the next in its allegiance to shareholder value creation. Few economists seemed to question this culture as the rising stock prices and firm valuations translated into vast wealth for so many.

Three significant economic events of the last decade have reshaped how the public feels about an unbridled devotion to shareholder value: the dot.com bubble; the accounting scandals headlined by Enron and Worldcom; and, finally, the recent meltdown of the credit markets. In each of these events, CEOs have been portrayed as reckless and greedy while Wall Street now appears to have become an object of scorn.

The concept of shareholder value maximization is central to the teaching of finance. Open any finance textbook and you will find a statement to the effect that the goal of the firm is to maximize the value of shareholders' equity.¹ This goal reflects the basic idea that managers are corporate employees who have been hired to act as agents for the firm's shareholders, who are in a sense the firm's owners. In a more precise formulation, the common stockholders are the "residual claimants" to the firm's earnings, with some control rights over the firm's assets and operations. And the public corporation itself is viewed as a "nexus of contracts" in which all participants other than the stockholders are compensated in accordance with the terms of their contractual agreements with the firm.

Viewed from the perspective of the entrepreneur who launches and runs his or her own business, it is easy to accept the notion that owner interests are paramount. But should the common stockholders of large, public corporations be thought of as owners in the same way we think of entrepreneurs? Specifically, does providing passive capital as a

stockholder in a large public corporation carry with it the same set of rights and privileges as providing active owner capital?² If so, should these shareholder rights and privileges be placed above those of the non-investor stakeholders of the corporation? Or should corporate managements put the interests of employees and local communities on something close to an equal footing with those of its shareholders? Is there really something to the rhetoric surrounding "Joe the Plumber" and the idea of "spreading the wealth?"

These are not easy questions to answer. Nor has society's attitude toward these issues remained constant. Throughout history economic crises have fostered concerns that a single-minded focus on shareholder interests can be economically shortsighted as well as socially divisive. Moreover, such concerns have encouraged some to advocate a broader view of the goal of the firm that incorporates multiple stakeholders. For example, in a *Harvard Law Review* article published three years after the stock market crash of 1929, Merrick Dodd (1932) argued that if the corporation can be viewed as an entity that is separate from its shareholders (as is implied by court rulings that granted corporations constitutional protections similar to those guaranteed citizens), then that entity has citizenship responsibilities. Specifically, management's role was not solely to act as the fiduciary of shareholders, but more like a trustee charged with carrying out the corporation's responsibilities for all corporate constituencies, even if it means a loss of shareholder value.³ The modern-day incarnation of this stakeholder view is called "corporate social responsibility," or CSR.

CSR is a corporate objective whereby business organizations are asked to consider and assume responsibility for the impact of their activities on customers, suppliers, employees, shareholders, communities and the environment in all aspects of their operations. CSR distinguishes itself from the basic notion of good citizenship in that it asks businesses to go beyond their

1. Brealey, Myers, and Marcus (2007) state the goal of the firm as follows: "A smart and effective financial manager makes decisions that increase the current value of the company's shares and the wealth of the stockholders." Brigham and Houston (2000) introduce the notion of social responsibility in the context of the goal of the firm but conclude by saying that "...throughout this book we operate on the assumption that management's primary goal is stockholder wealth maximization, which translates into maximizing the price of the firm's common stock." They further state that "the same actions that maximize stock prices also benefit society." Ross, Westerfield, and Jordan (2008) put it this way: "The goal of financial management is to maximize the current value per share of the existing stock."

2. John Mackey, CEO for the Whole Foods Corporation, stated his belief that the company founders hold special rights in the following statement: "...I believe the entrepreneurs, not the current investors in a company's stock, have the right and responsibility to define the purpose of the company." (Proxy Statement, 2007).

3. As good as this argument might sound to those who push for more socially responsible corporations, the skeptic might respond that the only duty that any citizen owes to society is to abide by its laws. We are indebted to legal scholar Charles North for pointing this out to us.

statutory obligation to comply with the law and voluntarily take steps to improve the quality of life of their employees and their families, the local community, and society at large.⁴

The wave of corporate scandals at the close of the 20th century involving Enron, WorldCom, and others gave rise to a new wave of concerns about an economy that focuses all business activity on stockholder interests. The more recent meltdown in the credit markets that led to the bankruptcy of old-line investment banks Bear Stearns and Lehman Brothers, and government takeovers of Freddie Mac, Fanny Mae, and AIG will almost certainly re-energize proponents of CSR and the stakeholder view of the public corporation. And the result, once again, is that failures in the financial markets are being attributed to managerial greed in the guise of maximizing shareholder value.

The aim of this article is to explore the conceptual underpinnings of the goal of maximizing the value of the equity of a publicly traded corporation. We develop an argument that supports some elements of CSR in the context of the value of honoring implicit contracts. In light of this argument, value maximization and CSR have the potential to be complementary undertakings that, when practiced strategically, can result in a virtuous circle in which “doing good” can help companies do well, and doing well provides the wherewithal to do more good. We refer to this integration of shareholder value with CSR as “Value(s)-Based Management.”⁵

What's Right about Maximizing Shareholder Value?

The case for using shareholder maximization as a guide to the management of the modern for-profit corporation rests on two main perspectives: (1) legal and (2) economic. Although most finance scholars find these points of support persuasive, popular support for the shareholder primacy goal, as we noted earlier, has ebbed and flowed in response to the state of the economy.

The legal underpinnings of the primacy of shareholder interests are well established in case law. For example, in 1919 the Michigan State Supreme Court provided the following opinion regarding shareholder primacy:

The business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself; to reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.

— *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919)

Although case law establishes that the fiduciary duties of the corporate directors to the shareholders and only the shareholders, there are a number of instances where non-shareholder interests have been written into law. For example, during the 1980s several states passed laws that, with the aim of blocking hostile takeovers, broadened the responsibilities of managements and boards to take account of the interests of non-shareholders. Minnesota passed a statute in 1987 that allows companies “in considering the best interests of the corporation, to consider the interests of the corporation’s employees, customers, suppliers and creditors, the economy of the state and the nation, community and societal considerations.”⁶ In 1990 the state of Pennsylvania, when enacting one of the most restrictive anti-takeover laws in the country, included a provision instructing the corporate directors to weigh the impact of any proposed change in corporate ownership on all stakeholders, including employees, customers, suppliers, and members of the local community.

At the heart of the debate between shareholder primacy and stakeholder theory there appears to be a fundamental disagreement about the best way to govern the corporation. The proponents of shareholder primacy argue that government should set the rules of the game and allow private enterprise to do what it does best—seek to make profits for the firm and its shareholders. The underlying assumption is that government is both willing and able to set the rules of the game in a way that protects the interests of non-owner stakeholders in the economy. In such a world, the firm’s management will behave in a socially responsible manner simply by “following the rules” and acting within the boundaries of the law.

The economist’s argument for maximizing shareholder value rests on the belief that pursuit of this goal serves the public interest by maximizing social wealth. This idea can be traced back to Adam Smith’s concept of the invisible hand:

*Every individual endeavors to employ his capital so that its produce may be of greatest value. He generally neither intends to promote the public interest, nor knows how much he is promoting it. He intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end, which has no part of his intention. By pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it.*⁷

Modern-day financial economists who support the goal of maximizing shareholder value do so in the belief that, by seeking to maximize their own value, companies work to maximize the collective wealth of the economy. Moreover, as Michael Jensen argued in a 2001 article called “The Corpo-

4. For a discussion of current trends in CSR, see Barbara Lougee and James Wallace, “The Corporate Social Responsibility (CSR) Trend,” *Journal of Applied Corporate Finance*, Winter 2008.

5. A complete discussion of these ideas can be found in our book, *Value Based Man-*

agement with Corporate Social Responsibility (Oxford University Press, 2009).

6. Statute 302A.251 (5), (Supplement 1988). Pennsylvania leads all states with eight anti-takeover laws.

7. Adam Smith, *The Wealth of Nations* (1776).

rate Objective Function: Value Maximization vs. Stakeholder Theory,” having multiple objectives focused on different corporate stakeholders is equivalent to having no objective at all, since it is impossible to maximize in more than one dimension at the same time.⁸ The interests of a company’s different stakeholders are often at odds with one another. Customers want quality products at low prices, employees prefer high compensation with pleasant working conditions, communities desire corporations that give to local causes. And since such preferences are inconsistent—certainly at least in the short run—with high returns to shareholders, all these objectives cannot be maximized simultaneously. So how are the necessary trade-offs to be made?

As Jensen points out, a single objective that links all vital inputs provides management with the guidance it needs to make the value-maximizing trade-offs among corporate stakeholders. But with multiple and competing objectives, managers lack an overarching objective (e.g., social welfare) that is required to make the kinds of trade-offs that invariably have to be made. For example, if an older plant facility is no longer competitive, pursuit of the shareholder interest might dictate closure as the best course of action. On the other hand, closing the plant could have negative consequences for the plant’s workers, who might be forced to suffer the costs of uprooting their families and moving or accepting lower-paying jobs. Stakeholder theory would suggest that management should somehow balance the interests of the firm’s shareholders who would benefit from closing the plant with the interests of the employees and the residents of the local community.

But this brings us back to the importance of the trade-offs that must be made by corporate managers and the question raised by them: “Is it the responsibility of corporate management to take account of these broader social effects, or should it focus mainly on maximizing value while leaving the direct protection of social interests to government through its laws and regulations?” Stakeholder advocates would argue that it is the responsibility of corporate management to take all the consequences of their decisions into consideration. Shareholder advocates would argue that shareholder interests alone should be the guiding principle in corporate decision-making.

This doesn’t mean that the impact of the plant closing on employees and the community should not be taken into account in making the closure decision. What it does say, however, is that enlightened self-interest should guide

managerial decisions. In other words, it might be economically beneficial to run an unprofitable plant for some period of time until a newer, updated plant can be built nearby. The benefit of continuing to run the plant in such a case would be to keep a talented and trained workforce in place until it can be redeployed in the new plant. But it’s important to keep in mind that the primary motive for “doing the right thing” in this case is the interests of the firm’s stockholders. In this instance, doing what is good for employees is also good for the longer-run prospects and value of the business.⁹

What’s Wrong with Shareholder Value Maximization?

Shareholder value maximization does not always result in the maximization of social welfare. Moreover, even if maximizing shareholder value is the *right* thing to do, there are practical problems that are encountered in implementing the goal that can limit its effectiveness.

Two fundamental linkages are needed if the goal of shareholder value maximization is to lead to the improvement in social welfare:

- First, maximizing the value of the common shareholder’s investment must be equivalent to maximizing the overall wealth being created by the corporation.
- Second, maximizing the wealth created by the firm must be consistent with maximizing social welfare.

When either of these linkages is broken, pursuit of shareholder value maximization may not maximize social welfare.

When Maximizing Shareholder Value Does Not Maximize Firm Value

Is looking after shareholder interests the same as maximizing the value of the firm? Support for this argument generally arises from what economists, following Michael Jensen and William Meckling, have called the “agency” view of the firm.¹⁰ The basic idea, as stated earlier, is that stockholders are the residual claimants while the economic interests of all other stakeholders are defined and limited by contracts. In this world, the non-shareholders realize their “just rewards” for their participation in the success or failure of the firm through their contractually defined returns. The stockholders receive what remains after paying the contractual claims of the others.

But what happens to this argument if the claims of non-shareholder participants cannot be fully protected by contract? For example, if management increases the overall

8. Except in the special case where the dimensions are all monotonic transformations of one another. See Michael Jensen, “The Corporate Objective Function: Value Maximization vs. Stakeholder Theory,” *Journal of Applied Corporate Finance*, Vol. 14 No. 3, Fall 2001.

9. Let’s consider the same example but assume that there are no economic benefits to the firm’s shareholders from “maintaining a trained workforce in place” since the value of their training has been superseded by a new technological innovation. What if the firm’s management now keeps the plant open because it is the right thing to do for the employees of the plant? In this case the firm’s management is freezing in place an old

technology and operating at higher cost than competitors who adopt the new technology. The painful truth is that this strategy, no matter how well intended, is doomed to failure. Change to the new lower-cost production technology is inevitable in a competitive market and the jobs will ultimately be lost because of the actions of the firm’s competitors. Nevertheless, even in this case, the reputation benefits to the firm from the way in which it decides to close the plant (i.e., severance benefits, retraining, etc.) may be such that the firm does not simply shut down the plant immediately.

10. Jensen and Meckling, (1976). Legal scholars refer to this as a “contractarian” view of the firm (represented by Easterbrook and Fischel, 1991).

risk of the business and the company's creditors are unable to adjust the terms of their loans to reflect the firm's higher risk, the stockholders will receive an "involuntary wealth transfer" from the creditors. Although such a wealth transfer represents a gain for stockholders, to the extent this gain comes at the expense of the firm's creditors, it may have no net social benefits.

When Maximizing Firm Value Does Not Maximize Social Welfare

The general link between increasing value and increasing social welfare is itself liable to criticism and must also be qualified. Specifically, the problem of contract protection extends beyond the set of participants who have explicit contracts with the firm to include others whose economic well-being affects or is affected by the firm. For example, there are members of society who are affected by the firm's actions who have no explicit contractual claim on the corporation's earnings, but who may still contribute to its success and suffer from its failures.

Here we are referring to the side-effects or unintended consequences of corporate actions that economists call "externalities."¹¹ A classic case is the pollution that results from some industrial processes, and where the failure to capture the social costs of pollution in the price of the goods results in excessive output. In the absence of significant externalities, all parties to an economic transaction are assumed to benefit, thereby improving the overall welfare of society. But when there are significant externalities, the connection between maximizing shareholder value (and firm value for that matter) and maximizing social welfare becomes tenuous.¹²

Monopolies pose another problem for value maximization. Companies with monopoly power can restrict their output and access to their markets. Since monopolists set their output at levels where consumers value a dollar of incremental product at more than a dollar, monopolies produce less than the social welfare optimum.¹³ But once again, limiting the costs of monopoly is a proper role for government—one that is generally carried out by the antitrust division—not an argument for jettisoning the goal of value maximization.¹⁴

Problems of Implementation

At least two problems arise when attempting to implement the goal of maximizing shareholder value. The first relates to questions about the reliability of stock prices as a guide to the long-run value of the firm's common stock. The better prices are at capturing the true value of the firm's shares, the more confidence we can have that stock price performance is a reliable indicator of value being created for shareholders.

The second problem relates to the difficulties encountered in defining a measure of firm performance that is reliably connected to stock price. Attempts to define "the best" measure of corporate performance have given rise to "metric wars" among competing consulting firms attempting to sell their particular approach to "value-based management."

Doubts about Market Efficiency

From society's perspective, shareholder value maximization is the appropriate goal only if the observed market price of the company's shares is a reliable estimate of the long-run value of the equity. For this to be true, the investors who buy and sell bonds, stocks, and other financial securities must do a reasonably good job of reflecting publicly available information in the prices of those securities.

Are financial markets efficient in this sense? Few would take the position that the financial markets are 100% right all the time. For instance, many now believe that waves of investor sentiment can lead to periods of overpricing, with the collapse of the dot.com market in 2000 offering a recent example.¹⁵ At the same time, however, the bulk of the academic evidence regarding market efficiency suggests that, with rare exceptions, financial markets provide unbiased estimates of value—that is, neither consistently too high or low on average. Burton Malkiel (1993) provides the following middle-ground assessment of the evidence on efficient markets:

I do not argue... that the market pricing is always perfect. After the fact, we know that markets have made egregious mistakes as I think occurred during the recent Internet bubble. Nor do I deny that psychological factors influence securities prices. But I am convinced that Benjamin Graham was correct

11. An externality is an impact (positive or negative) on any party not involved in a given economic transaction. An externality occurs when a decision causes costs or benefits to third party stakeholders, often, although not necessarily, from the use of a public good. The idea is that the participants in an economic transaction do not necessarily bear all of the costs or reap all of the benefits of the transaction. Clearly, where externalities are present in carrying out the business of the firm, the link between the goals of maximizing shareholder value and maximizing social welfare can be broken.

12. Economists have suggested two kinds of solutions to the problem of externalities and the goal of the firm. The first relies on private markets and the second on government as a rule maker. The private market solution, proposed by Nobel laureate Ronald Coase, is that in cases where the losses and gains from the externality accrue to two different parties, the parties negotiate a compensation of the losers by the winners that aims to achieve the socially optimal output. Alternatively, where a private market solution is not feasible (say, in cases where property rights are not well defined), the government must step in and exercise its rule-setting function (say, by imposing taxes on polluting companies or the users of their products).

13. Microsoft's difficulties in the European Union derive from what its competitors charge are actions designed to extract the maximum advantage from their near-monopoly for as long as they can get away with it (Baker, 2006).

14. Paradoxically, the merits of a market based economy are largely built upon the advantages of an atomistic, competitive market. However, business schools and strategy experts in particular, focus their energies on finding ways to create competitive advantage (i.e., to capture a degree of monopoly power).

15. Moreover, there are some well-known cases where the law of one price appears to have been violated. For example, when 3-Com Corporation spun off Palm Pilot in early 2000 (at the heart of the Internet boom), 5% of Palm Pilot shares were distributed to the public with 95% retained by 3-Com. In the initial trading of the Palm Pilot shares, the implied value of 3-Com's 95% holdings, based on the price of the 5% traded shares, exceeded the value of 3-Com. This implied a negative value for the remainder of 3-Com that was not made up of the Palm Pilot shares.

in suggesting that while the stock market in the short run may be a voting mechanism, in the long run it is a weighing mechanism. True value will win out in the end.

Maximizing Shareholder Value is Hard to Do

Even if we believe that maximizing shareholder value is the right objective, implementing it is far from easy. For the goal to be an effective motivator, employees' actions must be reliably linked to changes in shareholder value, and employees' pay must reflect their contribution to the changes in shareholder value.

Managers are paid periodically based on an evaluation of their performance for the period just ended. For shareholder value maximization to be an effective goal, we need a way to measure the effect of their actions during a past period on shareholder value (which is a function of the expected future cash flows earned by the firm for its shareholders) and reward them accordingly. In other words, we need a measure of periodic performance that, at least in theory, captures the contributions of *current* managerial actions on the value of *future* cash flows.

Defining such a performance measure has been a topic of great importance to management consultants. In fact some consulting firms have constructed the majority of their practice around a proprietary measure of performance they tout as the best link between managerial performance and changes in the firm's stock price. Such performance measures include economic value added (or EVA), residual income,¹⁶ return on invested capital, and the like.¹⁷

Having identified what management feels is a workable measure of performance that is linked to shareholder value, the next step is to identify major factors that contribute to achieving the performance goal and are under the direct control of management. Such factors are called "value drivers," and the requirement that they be under the control of the managers being evaluated is commonly referred to as the "line of sight" requirement.

The second condition for designing a firm to maximize shareholder value is that management must be motivated to follow the goal. This requirement is typically interpreted to mean that the economic self-interest of management must be aligned with the interests of the firm's stockholders. By "aligned" we mean that when managers make a choice that increases the value of the firm's shares, the managers are rewarded through an increase in their incentive compensation.

One of the commonplaces of the management literature is "what gets measured (and rewarded) gets managed." Unfortunately what is measured is not always what needs to get done, and what gets rewarded is not always what is being

measured. Because reward systems have the power to create unintended and unwanted consequences, considerable care must be taken to get the measure right.

Finally, however, management must recognize that any metric, regardless of how thoughtfully chosen, is just a measure—and therefore liable to being gamed by opportunistic managers and employees. Metrics do not get things done, people do. And the more tightly the rewards are tied to the metric, the more people will strive to maximize the metric. And therein lies the problem. Metrics—even stock prices, to some extent—are inevitably flawed proxies for value creation. And because wealth creation in this sense arises from multiple value drivers, too narrow a focus on the metric, without proper attention to the many drivers, can lead to unintended outcomes.

A nice example of this comes from Jack Welch's book, *Straight from the Gut*. There Welch tells of his surprise at an exceptional fourth quarter revenue line without any increase in income to go with it. On asking what had happened, he was told that there had been a fourth quarter sales contest and that everyone had done a great job. When he further asked where the margin was, he was told that the contest did not ask for margin.

Broadening Concern for Stakeholders

A compelling case can be made for broadening corporate concern for non-shareholder stakeholders to reflect the practical realities of doing business in an environment where complete and enforceable contracts with stakeholders are not always possible. Specifically, we propose a rationale for corporate social responsibility based on the concept of honoring the non-contractual claims of the firm's non-shareholder stakeholders—claims that arise from what amount to *implicit* contracts. As noted earlier, we refer to this effort to reconcile the aims of value maximization and CSR as *Value(s)-Based Management*.

Implicit contracts, unlike their explicit counterparts, are not represented by formal signed agreements and cannot be enforced by the courts. Rather, they are informal agreements based on relationships among the participating parties that are based solely on trust that the terms will be honored. Part of the incentive to honor these implicit contracts comes from the value of the firm's reputation. This concern about reputation, reinforced by the natural desire of (most) people to keep their promises to others, provides an economic basis for doing business in a world where writing and enforcing explicit contracts can become prohibitively expensive or impossibly complex.

Thus, in situations where the cost of writing and enforcing contracts that cover every possible contingency is

16. Stern Stewart & Co. built their consulting practice around their variant of residual income known as Economic Value Added (EVA).

17. For a review of this literature see Martin, Petty, and Wallace (2009).

prohibitively expensive, companies rely on relationships and the implicit contracts that govern them.¹⁸ And a reputation for being trustworthy is critical for companies—and indeed a major contributor to the value of their “brand”—when entering into implicit contracts with their stakeholders. For example, companies make implicit promises to their customers of continued support for the firm’s products. Companies enter into supply agreements with the implicit promise to deal fairly with their suppliers in the future as conditions change. And firms enter into implicit contracts with employees to provide them with opportunities for advancement if they perform in a satisfactory manner. Although none of these promises is written down or enforceable in court, honoring such agreements will be in the economic self-interest of the firm’s shareholders in most circumstances short of calamity. By so doing, the firm builds a reputation that it can be trusted to deal fairly with its customers, suppliers, and employees. And as a direct consequence, it improves the terms on which each of these groups transacts with the firm.

Why Should Companies Care about CSR?

There are important elements of corporate social responsibility (CSR) that are relevant to the goal of shareholder value maximization. Specifically, honoring implicit contracts with stakeholders is both valuable to the firm’s shareholders and consistent with important elements of CSR.

As just discussed, a good reputation has long been recognized as a source of value. For example, studies have shown that a reputation for producing quality products or services often enables companies to charge premium prices,¹⁹ attract better employees,²⁰ and improve their access to financial markets.²¹ And as these findings would lead us to expect, research has also confirmed that companies with better reputations tend to have better operating performance.²² Thus, there is reason to believe that companies with stronger reputations (all else being equal) have higher equity valuations. But such findings raise questions about the extent to which reputation contributes to improved performance, or whether the superior performance is responsible for a favorable reputation.²³ Causality here is likely to go both ways.

Although it is difficult to place a value on a company’s reputational capital, a number of studies have documented significantly negative effects on value by events that tarnished corporate reputations. For example, one study showed that airline crashes were associated with significant losses in the

value of the carriers’ common stock.²⁴ Since airlines are insured for the bulk of the losses, the negative share price effects are likely attributable to the effect on the carrier’s reputation for safety, and its consequences for future sales. And more recent research reported evidence of losses in value in response to the announcement of companies’ involvement in criminal fraud. Specifically, the study concluded that the resulting losses in equity value suffered by the affected firms were too large to attribute to expectations of impending legal sanctions alone.²⁵

The losses in reputational capital cited above took the form of negative market reactions to specific incidents such as airline crashes and allegations of fraud. But there are more subtle mechanisms for disciplining companies that fail to protect their reputational capital. As one example, the Consumer’s League conducts an annual survey of consumers’ views of corporate commitments to socially responsible behavior—and, more specifically, as the survey showed, to corporate commitments to their communities, employees, and the environment. The latest survey suggests two possible ways in which a firm’s reputation for CSR can affect shareholder value. One is through individuals’ investment decisions. For example, 63% of the respondents said that a company’s record of corporate social responsibility played an important role in their decision to invest.²⁶ The second way that CSR perceptions affect shareholder value is through consumers’ decisions to purchase the firm’s products or services. Over a third of the survey respondents said that a company’s reputation for socially responsible behavior was an important factor in determining their loyalty to the firm’s brand.

Yet another source of investor pressure for CSR is activist investors. For example, in a 2006 *Harvard Business Review* article, Michael Porter and Mark Kramer reported that, in 2005 alone, investors filed 360 different CSR-related shareholder resolutions, with concerns that ranged from labor conditions to global warming.²⁷

In 2007, a survey by Grant Thornton of 500 business executives reported a widespread belief that CSR can positively affect their bottom lines. The three greatest benefits were said to be improvements in: (1) public opinion, (2) customer relations, and (3) ability to attract and retain talent. Although environmental policies, community involvement, and human rights records may not have been important to previous generations of recruits when selecting potential employers, times appear to have changed.

18. Macaulay (1963) found that reliance on formal contracts and the threat of legal sanctions was a rare event in inter-firm relationships. Moreover, he found that relational (implicit) contracts involving the threat of the loss of future business was the primary tool for enforcing contracts.

19. Klein and Leffler (1981) and Boyd, Carroll and Dess (1995).

20. Stigler (1962).

21. Beatty and Ritter (1986) and Milgrom and Roberts (1986).

22. Roberts and Dowling (1997).

23. Rose and Thomsen (2004).

24. Borenstein and Zimmerman (1988).

25. Karpoff and Lott (1993).

26. In 2005, for example, investors in the US allocated approximately \$1.7 trillion to socially screened portfolios (Social Investment Forum, 2006. http://www.socialinvest.org/areas/research/trends/SRI_Trends_2005.pdf).

27. Porter and Kramer (2006).

Managing a Firm's Reputation

Our perspective on CSR in general, and on a firm's reputation for honoring its implicit contracts in particular, is guided by the goal of shareholder wealth maximization. This means that enlightened shareholder self-interest rather than altruism is our guide.²⁸ We use the term "enlightened shareholder self-interest" to emphasize the fact that the maximization of shareholder value involves more than meeting the firm's explicit contractual obligations. Specifically, as discussed earlier, it is in the interest of the firm's shareholders to manage the firm's reputational capital by making good on implicit promises to non-investor stakeholders.

To be sure, the need for companies to invest in promoting their reputations for providing high-quality goods and services is not as great in markets where the quality of the goods and services can be readily verified at the time of the purchase. Most commodities would fall into this category—though even here the seller's reputation for providing a dependable source of supply with on-time deliveries can be critical. But reputation is likely to be critical in cases where quality is difficult to verify at the time of the purchase. An example of the latter would be large construction projects where the ultimate quality of the project is revealed only over an extended period of time.

Our emphasis on corporate reputation is based on its potentially important effects on the firm's ability to conduct business in a way that maximizes shareholder value. Specifically, reputation is most important when the use of traditional (explicit) contracts is infeasible or impractical, perhaps because legal enforcement is too costly or quality cannot be legally confirmed in court.²⁹

Unfortunately the linkage between shareholder value and a positive corporate reputation is a fuzzy one. The basic problem can be thought of as involving two related, but separate decisions: First, identifying the types of activities that contribute to building and maintaining a "good" corporate reputation; and, second, deciding how much of the firm's resources to allocate to the task.

The task of managing a firm's reputational capital reduces to three basic types of activities: risk management, reputation management activities, and public relations. The importance of risk management is captured in Benjamin Franklin's likening of reputations to glass china, with both being "easily cracked but never well mended." Reputation management consists of programs and initiatives intended to improve or manage the firm's relationships with various stakeholder groups. The firm's public relations efforts gain their impor-

tance from the fact that reputations are based in large part on perceptions as well as objective and observable evidence, and that the two kinds of knowledge, while often consistent with one another, are almost never identical. In a world where information about the firm is increasingly available through the Internet and disclosures are mandated by the regulatory authorities, it is ever more important for companies to be aware of and actively manage their public image.

Risk management as it pertains to corporate reputation is directed toward identifying events that could damage the firm's reputation and taking action to prevent them. After identifying such risks, there are three possible courses of action: (1) risk acceptance—a decision that the cost of dealing with the risk and the potential loss of reputation are such that nothing will be done; (2) risk transfer—presumably in cases where the cost of insurance to transfer the risk is less than the potential losses incurred should the risk materialize; and (3) risk mitigation—this approach involves instituting controls that reduce or eliminate the risk.

Perhaps the best-known type of reputation management activity or program is corporate philanthropy. There is some evidence that companies that make charitable contributions and have their own charitable foundations have better corporate reputations than their counterparts.³⁰ On the other hand, there is also evidence that much if not most of a company's public image derives from its competitive performance.

In their *Harvard Business Review* article cited earlier, Porter and Kramer propose a strategic approach to thinking about the creation of CSR activities that can yield social benefits while also contributing to profitability and value. The key to their approach lies in identifying activities that have a shared social and corporate objective. As one example, they point out that the mining company Anglo American depends on local labor in Africa for its operations. In this case funding and otherwise supporting a program that addresses the AIDS pandemic in Africa is a social activity with a direct impact on the firm's business. Similarly, Microsoft's Working Connections partnership with the American Association of Community Colleges addresses Microsoft's need to staff IT positions while providing employment opportunities for community college students.³¹

Concluding Remarks

This article makes the case for viewing some elements of CSR as potential contributors to shareholder value. CSR activities can be valuable in helping companies develop and maintain

28. This goal is consistent with both Jensen (2001) and Porter and Kramer (2006). Jensen discusses enlightened stakeholder theory as stakeholder theory that recognizes the preeminence of shareholder wealth maximization as the goal for the firm. Similarly, Porter and Kramer define the essential test that should guide a firm's CSR efforts in terms of those that create an opportunity to create shared value—that is, a meaningful benefit for society that is also valuable to the business (p. 8).

29. Dybvig and Spatt (1985) argue that the potential loss of future business from a damaged reputation is an important mechanism for minimizing owner-manager agency problems.

30. Fombrun and Shanley (1990) found that firms that have foundations and give proportionally more to charity than other firms have higher reputations. Reputation was measured using an index constructed from a *Fortune* survey of corporate reputations carried out in 1985.

31. In both these examples of social program initiatives by private companies the free-rider problem looms large. For example, junior college graduates in IT may not go to work for Microsoft but may instead choose a competitor.

their reputation for fair dealing with each of its stakeholder groups, including employees, suppliers, and local communities. Such reputational capital in turn helps the firm to reinforce the commitment of those stakeholders through what amount to informal or implicit contracts. Indeed, without the willingness of suppliers, customers, employees, and members of the community to cooperate with the firm based on such implicit reciprocal commitments, some types of business transactions would never get done. In this sense, a reputation for honoring its promises is critical to a company's long-run success.

Having said this, the difficulties of balancing stakeholder interests against the overarching goal of efficiency and value maximization cannot be overstated. As with any corporate investment, each dollar of investment in a corporate stakeholder group should be justified by at least a dollar of expected return over a finite time horizon (and adjusted, of course, for the time value of money). By practicing this kind of enlightened value maximization, companies would view CSR not as

a cost that is *imposed* upon the shareholders, but rather as an opportunity to invest (and create value) in its relationships with all of its important constituencies. In so doing, management is likely to end up not only increasing its returns to shareholders, but enlarging the size of the corporate pie that is divided among all its stakeholders—the ultimate win-win situation.

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